No. 552

In the Supreme Court of the United States

OCTOBER TERM, 1942

INTERSTATE TRANSIT LINES, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 14–19) is reported at 44 B. T. A. 957. The opinion of the Circuit Court of Appeals (R. 70–78) is reported at 130 F. 2d 136.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 31, 1942 (R. 78–79). Petition for rehearing was denied September 8, 1942 (R. 82). Petition for a writ of certiorari was filed November 28, 1942, and was granted on March 8, 1943 (R. 87). The jurisdiction of this Court

rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a deficit incurred by a wholly owned subsidiary of the taxpayer and paid by taxpayer pursuant to contract was deductible from gross income as an ordinary and necessary expense in carrying on the business of the taxpayer, under Section 23 (a) of the Revenue Act of 1936.

STATUTE INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 13. NORMAL TAX ON CORPORATIONS.
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> * * * * *
>
> (b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation, a normal tax as follows:
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> * * * * *
>
> SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *
>
> * * * * *
>
> SEC. 52. CORPORATION RETURNS.
>
> Every corporation subject to taxation under this title shall make a return, stating specifically the items of its gross income and the deductions and credits al-

lowed by this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe. * * *

STATEMENT

The facts as found by the Board of Tax Appeals (R. 14–17) may be summarized as follows:

The taxpayer is a Nebraska corporation engaged since 1929 in the operation of interstate bus transportation lines between Chicago, Illinois, and Los Angeles, California, handling intrastate business in Iowa, Nebraska, Kansas, Colorado, Wyoming, Utah, and Nevada (R. 14). It was unable at the outset to handle intrastate business in California because the Railroad Commission of that State had refused to grant to foreign corporations authority for intrastate operation (R. 14–15). In 1930, the taxpayer, in order to increase its income by carrying California intrastate traffic, which it could do without substantial increase in its facilities or expenses, organized a subsidiary corporation, Union Pacific Stages of California, under the laws of California. The subsidiary was authorized to conduct intrastate operations in California. (R. 15.)

The taxpayer furnished all the capital of the subsidiary and held all its capital stock. The two corporations entered into contracts which provided that the subsidiary would operate on

such routes and schedules as would most benefit the taxpayer, as directed by the taxpayer, that the taxpayer would assume and reimburse the subsidiary for any operating deficits incurred by it, and that the subsidiary would pay to the taxpayer any profit resulting from its operations. It was further agreed that the subsidiary, in addition to operating its intrastate business, would also conduct the interstate operations of the taxpayer in California. (R. 15.)

The taxpayer and the subsidiary had the same officers and directors. The subsidiary had its own accounting records and corporate books which were kept in the offices of the taxpayer. The subsidiary had no bank account and taxpayer collected its revenues and paid its bills. The revenues and expenses of both corporations were apportioned between them on the basis of passenger and traffic miles. (R. 16.) The subsidiary owned two buses (R. 16), which it pooled with those of the taxpayer under a reciprocal lease arrangement (R. 15, 16).

For the calendar year 1936, the subsidiary incurred an operating deficit of $28,100.66 which was charged to the taxpayer as of December 31, 1936. A corresponding credit was entered upon the subsidiary's books on the same date. On December 31, 1936, before these entries were made, the subsidiary was indebted to the taxpayer in a net amount of about $34,000, so that the entries made with respect to the alleged deficit

of $28,100.66 merely reduced the net indebtedness of the subsidiary to the taxpayer by the amount of the deficit and left the subsidiary still indebted to the taxpayer in an amount exceeding $5,000. For the years 1932 and 1933, affiliated returns were filed by the taxpayer and the subsidiary. (R. 16–17.)

Several years after 1936, the taxpayer was able to obtain authority to conduct intrastate business in California and the subsidiary was therefore dissolved and its assets transferred to the taxpayer (R. 17).

The taxpayer sought to deduct the 1936 deficit of $28,100.66 of its subsidiary as an ordinary and necessary expense of its own business. The Commissioner disallowed the deduction and assessed the deficiency under review (R. 6–8). The Board sustained the Commissioner's determination (R. 17–19), and the Circuit Court of Appeals affirmed (R. 70–79).

SUMMARY OF ARGUMENT

The item which the taxpayer seeks to deduct from its taxable income is an operating loss sustained by another corporation, its subsidiary. If as contended by the taxpayer the subsidiary should be assimilated to it the net operating deficit loses all significance for tax purposes. As principal the taxpayer would have to report all the income received through the agent and could establish its right to deductions against such income by iden-

tifying particular expenditures as taxes, operating expenses, rental, depreciation charges, and the like. The asserted net operating deficit of the subsidiary may well have resulted in large part from expenditures nondeductible for income tax purposes. The Board of Tax Appeals did not make any finding respecting the expenditures that produced this operating loss. On this agency theory therefore the taxpayer's case must fall by reason of failure of proof to establish a right to any deduction.

Even if the taxpayer had established that it paid particular and deductible expenses of its subsidiary no right to a deduction by the former would have been established. The expenses of the subsidiary are its expenses alone. The argument that the subsidiary can be assimilated to the parent for tax purposes is contrary to the general rule that a corporation must be respected as a separate taxpayer. It is clear, moreover, that Congress intended that rule to apply to such cases as this. Section 13 of the Revenue Act of 1936 levies a tax on the net income of every corporation. Moreover, the privilege of filing consolidated returns by affiliated corporations was withdrawn by Congress in the Revenue Acts of 1934 and 1936 with full appreciation that such action would require such corporations as the taxpayer's subsidiary to file a separate return. Accordingly, the expenses of the subsidiary are deductible by it and not by the taxpayer.

The contention that the accrual of the contractual obligation to make good the subsidiary's loss makes that item an ordinary and necessary expense of the taxpayer is likewise without merit. That obligation cannot be explained as one to pay for service rendered by the subsidiary. Its nature is such that it could only be made between a sole stockholder and its corporation—an obligation to contribute additional capital to the corporation if needed. Accordingly, the accrual is simply one for a capital expenditure increasing the taxpayer's investment in its subsidiary.

In any event the expenditure could not be regarded as that of the taxpayer. It simply reimbursed the subsidiary for its losses and the taxpayer's payment thereof, though under contract, was simply the payment of another's expense. Any other view would permit parent and subsidiary corporations to effect by formal contracts and book entries the filing of a consolidated return for a tax year when Congress had specifically denied them that privilege.

ARGUMENT

While there was a close business relation between the taxpayer and its subsidiary, Union Pacific Stages of California (referred to herein as Stages), the circumstances under which Stages was organized and operated disclose the unreality of regarding the two businesses as one. The California Railroad Commission would not in 1930

permit taxpayer, as a foreign corporation, to carry intrastate passengers in California. Accordingly, the taxpayer[1] organized Stages as a California corporation and the latter was authorized to and did carry both intrastate and interstate passengers in California through the tax year in question. Thus, notwithstanding their community of business interest, there was from the beginning a legal cleavage between the taxpayer and Stages—one inevitably resulting from the taxpayer's act of creating another corporation and surrendering thereto a portion of its former activities, albeit the result of business necessity.

Prior to enactment of the Revenue Act of 1934 the fact that the taxpayer was one corporation while Stages was another had no necessary significance for tax purposes. From the Revenue Act of 1918 through the Revenue Act of 1932 provision had been made by Congress for the filing of a single return by affiliated corporations.[2] Inasmuch as Stages was a corporation wholly owned by the taxpayer the consolidated return privilege meant that the former's income and

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[1] Apparently the taxpayer in turn was a subsidiary of the Union Pacific Railroad Co. See R. 3, 38, 48.

[2] Section 240 of the Revenue Acts of 1918, c. 18, 40 Stat. 1057; 1921, c. 136, 42 Stat. 227; 1924, c. 234, 43 Stat. 253; and 1926, c. 27, 44 Stat. 9; Section 141 of the Revenue Act of 1928, c. 852, 45 Stat. 791, and 1932, c. 209, 47 Stat. 169, provided for consolidated returns of affiliated corporations generally. Similar provision appears in Section 141 of the Internal Revenue Code, as amended by the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., Sec. 159.

expenses of operation could be offset by those of the latter. In fact, for the years 1932 and 1933 the taxpayer and Stages, as affiliated corporations, did file consolidated returns (R. 17).

In the Revenue Act of 1934, however, Congress retained the consolidated return provision only with respect to affiliated railroad operating and holding companies.[3] The privilege of offsetting for tax purposes the losses of a subsidiary corporation against the parent corporation's income was denied to all other types of corporations. This was done by Congress, moreover, with full appreciation of the fact that subsidiary corporations are often little more than departments of the parent and created merely to satisfy local law.[4] The

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[3] Revenue Act of 1934, c. 277, 48 Stat. 680:

"SEC. 141. CONSOLIDATED RETURNS OF RAILROAD CORPORATIONS.

"(a) *Privilege to File Consolidated Returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. * * *

* * * * *

"(d) *Definition of 'Affiliated Group.'*—As used in this section an 'affiliated group' means one or more chains of corporations connected through stock ownership with a common parent corporation if—

* * * * *

"(3) Each of the corporations is either (A) a corporation whose principal business is that of a common carrier by railroad or (B) a corporation the assets of which consist principally of stock in such corporations and which does not itself operate a business other than that of a common carrier by railroad. * * *"

* * * * *

[4] See fns. 12 and 13, pp. 19–21, *infra*.

provisions of the Revenue Act of 1934 respecting consolidated returns appeared unchanged in the Revenue Act of 1936, save for the addition of certain electric railways to the definition of the affiliated railroad operating and holding companies entitled to file consolidated returns.[8] Not until the enactment of the Revenue Act of 1942 was the consolidated-return privilege again extended to corporations generally. (Section 159 of the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., amending Section 141 of the Internal Revenue Code (U. S. C., Title 26, Sec. 141).)

Under the Revenue Act of 1936, the taxpayer and Stages, affiliated bus companies rather than railroads, were not entitled to file a consolidated return. Despite this change in the statute, the taxpayer's attempt here is to offset against its own income for 1936 an alleged deficit of some $28,100.66 which was incurred in the operation of Stages' business.

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[8] Revenue Act of 1936:

"Sec. 141. Consolidated returns of railroad corporations.

* * * * *

"(d) *Definition of 'Affiliated Group.'*—

* * * * *

"(3) * * * As used in this paragraph, the term 'railroad' includes a street, suburban, or interurban electric railway.

* * * * *

I

ITS SUBSIDIARY'S NET LOSS IS NOT DEDUCTIBLE BY THE TAXPAYER

The contention is advanced, largely on the authority of *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, that Stages should be regarded as a mere agent and the deficit incurred in its operation held deductible by the taxpayer as a business expense on that ground alone.

Even if it is assumed, *arguendo,* that Stages was a mere agent or department of the taxpayer, the right to the claimed deduction is not thereby established. On the contrary, to be deductible for income-tax purposes the nature of an expenditure must be defined with considerable more precision than mere characterization as a net operating deficit on business transacted by an agent. Such a deficit, as well as not, may result from allocating to the agent charges that are not themselves deductible, i. e., federal income and excess-profits taxes, lobbying expenses, excessive depreciation, and the like. As a matter of fact it appears that one of Stages' principal expenses was "bus rental" (R. 63). If the buses rented were those owned by the taxpayer, as appears to be the case,[6] the incongruity of permitting the claimed deduction is clear. A principal could not directly claim a deduction for rent charged

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[6] The contract between the taxpayer and Stages called for each party as lessee to pay five cents a mile while in possession and custody of the other's buses (R. 15, 59).

by him against his agent. Nor can such an item become deductible by visitation with a balance sheet and emergence as a "net operating deficit". Indeed, if Stages is to be assimilated to the taxpayer then any payment to it would simply be a transfer from the taxpayer's right hand to its left, and such a transaction is manifestly insufficient to establish deductibility of anything. Cf. *Higgins* v. *Smith*, 308 U. S. 473. Just as *Southern Pacific Co.* v. *Lowe, supra,* disregarded the dividend payment by the subsidiary to the parent, so here its application would result in disregarding the payment by the parent to the subsidiary.

Deductions for business expenses are not established for purposes of the Revenue Acts (or for accounting purposes either for that matter) by reference to the year's net gain or loss on all business done. One engaged in business directly or through an agent is required to account with greater detail. If Stages were merely an agent then the taxpayer was required to report the gross income from all transactions handled by its agent. *Maryland Casualty Co.* v. *United States*, 251 U. S. 342; *Huntington Nat. Bank* v. *Commissioner*, 90 F. 2d 876 (C. C. A. 6th). Its right to deductions against all its income could only be established as depreciation charges, taxes, operating expenses, and the like.

The rule is elementary that deductions are a

matter of legislative grace and that the burden is on the taxpayer to establish all elements of his claim thereto. *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435. The Board of Tax Appeals has not even made findings respecting the nature or deductibility of the items that produced Stages' net operating loss for 1936. It seems clear, therefore, that acceptance of the taxpayer's theory that Stages was merely its agent would require decision that it has not established its right to any deduction.

There is yet another reason why the "agency" theory cannot establish the taxpayer's right to a deduction on the basis of Stages' net operating loss for 1936. Stages cannot for tax purposes be regarded as a mere agent of the taxpayer; rather, the two must be regarded as separate and distinct.

This case does not involve a situation where a subsidiary has been designated to act as an agent, with the principal thereby disavowing the particular advantages of having the business done separately as that of the subsidiary. The so-called "Absorption Agreement" between Stages and the taxpayer expressly recognized that the relation between the two was merely that of parent and operating subsidiary and that the operation of buses in California was the business of Stages as a California corporation (R. 57). Nor does this case involve a transaction in which

Stages' role could be described as transitory or ephemeral.[7] Stages was an operating corporation whose stock was wholly owned by the taxpayer, organized as a separate and distinct corporation in an area where the taxpayer had been unable to secure authority for full operation.

It was of the essence that Stages be regarded as the legally responsible entity in applying to the California Railroad Commission for a permit to operate as an intrastate carrier. Had the application been made by Stages as agent for the taxpayer the permit would not have been granted. The permit issued under these circumstances, i. e., to Stages, was the one under which operations

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[7] As indicated in the brief for the respondent in *Moline Properties, Inc.* v. *Helvering*, No. 660, October Term, 1942, there are several decisions holding realty corporations nontaxable on sale of property in certain situations. Cf. *112 West 59th Street Corp.* v. *Helvering*, 68 F. 2d 397 (App. D. C.); *McInerney* v. *Commissioner*, 29 B. T. A. 1, affirmed, 82 F. 2d 665; *Abrams Sons' Realty Corp.* v. *Commissioner*, 40 B. T. A. 653.

Where the realty corporation has been utilized as a medium for business activity, however insignificant, the tax consequence of such an unambiguous business decision cannot be escaped. *Higgins* v. *Smith*, *supra*; *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415; *Palcar Real Estate Co.* v. *Commissioner*, 131 F. 2d 210 (C. C. A. 8th); *Salmon* v. *Commissioner*, 126 F. 2d 203 (C. C. A. 2d).

Consistently with these latter decisions it is the Government's position, developed in greater detail in the brief for the respondent in *Moline Properties, Inc.* v. *Helvering*, *supra*, that every corporation is subject to taxation and is taxable on gains from sales of its property when its "ownership" is simply corporate ownership for the benefit of its stockholder.

were continued for the tax year involved here. Nor was the separation of Stages from the taxpayer limited to the representation made to the California Railroad Commission. Accounts were separately kept for the two corporations. Stages had its own employees, buses, directors and corporate minute books. By contract Stages was in physical possession of equipment of the taxpayer while used in California. Indeed, it was provided that as the respective companies took over the custody and possession of the buses a payment to the owners of five cents per mile run by each bus should be made and the "lessee" would be responsible to the "lessor" for the buses of the "lessor" in the "lessee's" custody and possesssion. The separation and responsibility of Stages is further evidenced by the nature of the item that occasions this litigation—an adjustment of the accounts between the two corporations on the basis of the business done by each respectively. In light of the reason for Stages' organization and the nature of the business carried on by it through the tax year in question, the taxpayer cannot now disavow the former's separate existence or legal responsibility. There is nothing in the record that indicates that Stages was ever represented as the taxpayer's agent or as a myth. Actually, it was scrupulously represented as a separate corporation. In short, Stages was an operating subsidiary corporation engaged in conducting its own

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business.[8] The business relation between the taxpayer and Stages, the former's ownership of the latter's stock, and the fact that they had common offices and officers, cannot convert Stages' role to that of a mere agent. Such an argument amounts to no more than a contention that Stages, should be disregarded as a separate and responsible entity for tax purposes.

This Court has often observed that, as a general rule, for tax purposes a corporation must be treated as an entity taxable as such distinct from its owner, even though there is but one stockholder and his or its relation with the corporation is therefore naturally close. *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415; *Dalton* v. *Bowers*, 287 U. S. 404; *Burnet* v. *Clark*, 287 U. S. 410; *New Colonial Ice Co.* v. *Helvering*, *supra*.[9] As stated in *Higgins* v. *Smith*, *supra* (p. 477)—

> A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.[10]

[8] The separate character of the subsidiary would defeat a claim that the taxpayer was doing business in California. Cf. *Cannon Mfg. Co.* v. *Cudahy Co.*, 267 U. S. 333

[9] State tax statutes are similarly construed by the state courts. See *Superior Coal Co.* v. *Department of Finance*, 377 Ill. 282, 36 N. E. (2d) 354; *Northwestern Pacific R. R. Co.* v. *State Board*, 21 Adv. Cal. 557, 133 P. (2d) 400.

[10] See also *Gray* v. *Powell*, 314 U. S. 402, 414, where in discussing an analogous problem under the Bituminous Coal Act this Court said:

"* * * The choice of disregarding a deliberately chosen arrangement for conducting business affairs does not lie with the creator of the plan."

In accordance with these decisions Stages must be regarded as distinct for tax purposes from the taxpayer and it is elementary that one taxpayer cannot have the benefit of another's deductions. *New Colonial Ice Co.* v. *Helvering, supra.*

In attempting to escape the impact of these principles the taxpayer relies chiefly on *Southern Pacific Co.* v. *Lowe, supra,* and *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71, for the proposition that Stages as a wholly owned subsidiary should be assimilated for tax purposes to the taxpayer. As pointed out in the brief for the respondent in *Moline Properties, Inc.* v *Helvering,* No. 660, now before this Court, however, those cases do not support that proposition. The issue presented in both was whether post-1913 dividends to the taxpayer corporation from the pre-1913 earnings of wholly owned subsidiaries were to be regarded as income accruing to the taxpayer after 1913. The decision was that the taxpayers' relation with their wholly owned subsidiaries was such that the income accrued to the former before the 1913 tax date. In the opinions in those cases and in *Burnet* v. *Commonwealth Imp. Co., supra,* at pp. 419–420, this Court has made it abundantly clear that these cases rest on their peculiar facts and do not support the general proposition that a wholly owned corporation and its owner are identical for tax purposes.

The peculiar fact which was the basis for those decisions sharply limits their significance. This

Court was of the view that Congress, in the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, had made clear its intention that no income earned and available to a taxpayer prior to 1913 should be taxed as income accruing thereafter. Cf. *Peabody* v. *Eisner,* 247 U. S. 347, 349. It was this view of the expressed will of Congress that dictated assimilation of wholly owned subsidiaries to the parent corporation in determining when income accrued. Thus these decisions, at most, stand for the proposition that wholly owned corporations may be identified with their owners for tax purposes when required to effectuate an expressed Congressional policy.[11] See *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435, 442.

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[11] The case of *Weiss* v. *Stearn,* 265 U. S. 242, was one growing out of a corporate reorganization. The decision, that the interest of the stockholders in the new corporation represented the same interest they had in the old, was based on the constitutional principle respecting realization of income enunciated in *Eisner* v. *Macomber,* 252 U. S. 189. Hence, the decision in *Weiss* v. *Stearn, supra,* is not pertinent to the issue of statutory construction presented here, i. e., whether the taxpayer may take a deduction for its subsidiary's net loss. Cf. *New Colonial Ice Co.* v. *Helvering, supra,* at p. 439. Moreover, *Weiss* v. *Stearn, supra,* is of dubious vitality in any event. See *Marr* v. *United States,* 268 U. S. 536, 542; Magill, *Taxable Income* (1936), 64; Finkelstein, *The Corporate Entity and the Income Tax* (1935), 44 Yale L. J. 436, 446.

Certain other decisions assimilating a corporation to its owner for tax purposes may be explained as resting on the premise that effectuation of an expressed Congressional policy required such corporate veil-piercing. In this connection reference is made to the decisions in *Munson S. S. Line* v. *Commissioner,* 77 F. 2d 849 (C. C. A. 2d); *Conti-*

There is, however, no recognizable or identifiable Congressional policy that requires nonrecognition of Stages as an independent taxpayer. On the contrary, Section 13 of the Revenue Act of 1936, *supra*, and its predecessors and successors levies a tax on the *net* income of *every* corporation. From a consideration of other provisions of the Revenue Acts respecting corporate taxation it is clear that Congress intended by Section 13 to tax the net income of every corporation irrespective of the nature of its activity or the number of its stockholders. (The material in the brief for the respondent in *Moline Properties, Inc.* v. *Helvering,* No. 660, develops this thesis in greater detail.) Taxing every corporation on its net income requires, of course, that items deductible in arriving at Stages' net income cannot be deducted in arriving at the taxpayer's net income. If there could be any question respecting Congressional intention in Section 13 to tax separately the net income of every corporation, including subsidiary corporations, however, it is

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nental Oil Co. v. *Jones*, 113 F. 2d 557 (C. C. A. 10th), certiorari denied, 311 U. S. 687; and *Inland Development Co.* v. *Commissioner*, 120 F. 2d 986 (C. C. A. 10th).

The decision of this Court in *Higgins* v. *Smith*, *supra*, that the Commissioner may disregard corporations that are unreal or such transactions as are sham, is based on the presumed Congressional intention that mere forms shall not operate to reduce the public revenue. See brief for the respondent in *Moline Properties, Inc.*, v. *Helvering*, *supra*, for discussion of this case.

completely dispelled by consideration of the legislative history underlying elimination of the general provision for consolidated returns from the Revenue Acts of 1934 and 1936.

As seen above, from the Revenue Act of 1918 through the Revenue Act of 1932, c. 209, 47 Stat. 169, Congress had provided for consolidated returns by affiliated corporations. During consideration of the bill that became the Revenue Act of 1934 both the House and Senate Committees reported favorably on retention of the provision for consolidated return by all types of affiliated corporations.[12] On the floor of the Senate, however, Senator Borah moved to strike the entire provision explaining that "If the motion should prevail, all corporations would make their separate and individual reports" (Cong. Record, Vol. 78, Part 6, p. 6463). The debate on the motion and the committee reports, referred to above, indicate complete awareness of the fact that many subsidiary corporations are formed with respect

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[12] H. Rep. No. 704, 73d Cong., 2d Sess., p. 17 (1939-1 Cum. Bull. (Part 2), 554, 566-567):

"Your committee considered at length the question of abolishing the consolidated return. Our subcommittee originally recommended this action. The Treasury believed this policy undesirable. The Treasury pointed out that the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, with all inter-company transactions eliminated. Otherwise, profits and losses may be shifted from one wholly owned subsidiary to another, and their separate statements of income do not present an accurate picture of the earnings of the group as

to interstate businesses simply to satisfy the requirements of local authorities, that they exist as little more than departments of the parent, and that to require separate returns in such cases might cause hardship.[13] Notwithstanding these considerations the Senate adopted the amendment striking the consolidated return provision (Cong. Record, Vol. 78, Part 6, p. 6466). Subse-

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a whole. For all practical purposes the various subsidiaries, though technically distinct entities, are actually branches or departments of one enterprise. For these reasons, consolidated statements of income have been the rule for ordinary business purposes, and for 16 years, the income tax law has provided for consolidated returns. The administration of the income tax law is simpler with the consolidated return since it conforms to ordinary business practice; enables the Treasury to deal with a single taxpayer instead of many subsidiaries; and eliminates the necessity of examining the bona fides of thousands of intercompany transactions.

"Consequently, after careful consideration of the question, the committee decided that it would be undesirable to abolish the consolidated return at this time. It appeared in the hearings that such action would be especially burdensome to many corporations, such as the railroads, which are frequently obliged to maintain separate corporate structures in the several States in which they operate, although for all ordinary business and accounting purposes, the subsidiaries form a single operating system. * * *"

A similar statement appears in S. Rep. No. 558, 73d Cong., 2d Sess., p. 18 (1939–1 Cum. Bull. (Part 2) 586, 600).

[13] See excerpts from the Committee Reports set out in fn. 12, *supra*.

In the debate on Senator Borah's motion to eliminate the consolidated return provision the following statement was made by Senator Harrison (Cong. Record, Vol. 78, Part 6, p. 6464):

quently, in connection with a motion for reconsideration of this amendment Senator Borah made clear the understanding that the Conference Committee could acceptably make some provision for consolidated returns in cases where special hardship would otherwise result (Cong. Record, Vol. 78, Part 6, p. 6555). The Committee, however, extended the consolidated return prerogative only to affiliated railroad operating

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"It has been thought by the committee that it is necessary in some cases that consolidated returns be filed. It was pointed out by the railroads, for instance, that it was necessary for them to file consolidated returns, and it must not be forgotten by the Senate that certain States have laws respecting the doing of business by corporations, which make it necessary that a corporation doing business in a State must organize under its laws. As an example, the Postal Telegraph Co., which has to institute eminent-domain proceedings in order to construct its lines, and so forth, I am informed, has to incorporate in practically every State: and so there are practically 48 different corporations under it, but it has one bookkeeping process. * * *"

On discussion of a motion to reconsider adoption of his motion Senator Borah observed (Cong. Record, Vol. 78, Part 6, p. 6555):

"It must be conceded that there are some companies which ought not to be permitted to enjoy the benefits of consolidated returns. It is claimed that there are other companies which possibly might be excepted from the effect of the provision as to consolidated returns, and in fairness and justice excepted. * * * If, however, there are corporations which it would seem to some ought to be excepted, that matter may be taken care of by the conferees. * * *"

For discussion in the House reflecting this appreciation of the fact that subsidiaries may be formed merely to satisfy local law, see Cong. Record, Vol. 78, Part 6, p. 6409, Part 7, pp. 7829, 7831.

and holding companies[14] and the Revenue Act of 1934 was enacted with only that limited provision for consolidated returns (Revenue Act of 1934, Section 141, *supra*). As seen above, the only change relative to the consolidated return provision effected in the Revenue Act of 1936 was inclusion of certain electric railways in the definition of railroads. A provision for consolidated returns by all affiliated corporations did not again appear until enactment of the Revenue Act of 1942 (Section 159 of the Revenue Act of 1942, *supra*).

In light of the fact that Congress had clearly before it the situation of such subsidiary corporations as Stages, the legislative decision reflected in the Revenue Acts of 1934 and 1936, denying parent and subsidiary corporations the consolidated return provision, is a clear mandate that their income-tax liability must be separately determined under those acts. It is therefore

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[14] H. Rep. No. 1385, 73d Cong., 2d Sess., p. 23 (1939-1, Cum. Bull. (Part 2) 627, 633):

"Amendment No. 73: This amendment eliminates section 141 of the House bill, permitting the filing of consolidated returns. The House recedes with an amendment restoring the privilege of making a consolidated return (granted by section 141 of the House bill) to any affiliated group of corporations each of which is either (A) a corporation whose principal business is that of a common carrier by railroad or (B) a corporation the assets of which consist principally of stock in such corporations and which does not itself operate a business other than that of a common carrier by railroad."

even clearer here than in the cases above cited that the separate entity and tax responsibility of the subsidiary corporation must be respected. Hence, business expenses, depreciation charges, and the like, allocable to business done by Stages, are deductible by it alone and may not be deducted by the taxpayer.

II

PAYMENT OF ITS SUBSIDIARY'S NET LOSS FOR THE YEAR IS NOT DEDUCTIBLE BY THE TAXPAYER AS AN ORDINARY AND NECESSARY EXPENSE OF ITS BUSINESS

The alternative contention advanced is that, by virtue of its contractual obligation to reimburse Stages for any operating deficits, the taxpayer is entitled to accrue as its own business expense the amount of the deficit incurred by Stages in 1936. It may again be noted that if Stages were a mere agent of the taxpayer this contention as well would fail to establish the taxpayer's right to a deduction. As seen above, a principal's income tax returns must reflect, not the balance on the agent's operations, but all items of income and deductible expense resulting from the agent's transactions. Thus the contention that an accrual for a business expense can be taken on the basis of a contractual obligation to make up Stages' deficits must rest on recognition that Stages is an entity separate and distinct from the taxpayer for tax purposes.

The essence of this contention is that the accrual under the contract represented an obligation to pay for service rendered the taxpayer by Stages. In connection with the nature of this obligation, however, the contract giving rise thereto is significant. By the terms of this contract Stages undertook to turn over all its profits to the taxpayer and the taxpayer in turn undertook to reimburse Stages for any deficits incurred in its operations. (R. 57.) This is certainly not the sort of an arrangement the taxpayer would have made with an independent carrier. Under this contract the stock in Stages would have been worthless to anyone other than the taxpayer. The contract, therefore, must be regarded as one which only a sole stockholder would make with its corporation and one made in lieu of contributing adequate capital to the corporation at the outset.

The nature of payments to be made to Stages is further shown by the fact that they were not measured by its expense or losses incurred in serving the taxpayer, i. e., by coordinating their schedules.[18] Stages, in fact, was compensated for carriage of the taxpayer's passengers by allocation of revenue to it on the basis of motor-coach miles and charge against that revenue of expenses for

[18] The schedules were coordinated in all years and yet payment was made only in 1936, when a deficit occurred. This indicates that the payment was not for the service, but to maintain the subsidiary's capital.

the most part apportioned on the same basis (R. 40-41). It is clear that the 1936 deficit of Stages did not result because of particular service rendered the taxpayer, i. e., by reason of Stages' practice of synchronizing its operations with those of the taxpayer. The net loss, rather, was a general one resulting from all Stages' operations—intrastate and interstate as well. It is noteworthy that the Board of Tax Appeals held that the evidence did not disclose what portion of the loss was attributable to Stages' intrastate operations in California (R. 18).

Consideration of these factors makes it clear that the contract of the taxpayer to make good Stages' operating deficits is one pervaded by the stockholder-corporation relation. Any contribution to Stages under this contract must therefore be regarded as incident to the taxpayer's stockholder status.

It is well settled that a contribution by a stockholder to replenish a corporation's impaired capital at a time when the corporation continues to function must be treated as a capital expenditure. This is true even though the payment is made under an obligation assumed on original purchase of the stock, and therefore involuntary. *Wichita State Bank & T. Co.* v. *Commissioner,* 69 F. 2d 595 (C. C. A. 5th), certiorari denied, 293 U. S. 562; *First Nat. Bank in Wichita* v. *Commissioner,* 46 F. 2d 283 (C. C. A. 10th); *Peyton Du-Pont Securities Co.* v. *Commissioner,* 66 F. 2d 718 (C. C. A.

2d). Cf. *Magruder* v. *Supplee,* 316 U. S. 394 (taxes paid by one who purchases realty after the tax lien therefor has attached must treat such payments as additional cost of the property and not as deductible taxes). The rule can be no different in the case of a contribution to a subsidiary corporation by the parent.

The fact of the stockholder-corporation relation is the dominant characteristic and certainly the only adequate explanation for a contract of the sort here presented. Moreover, there is nothing of unfairness in the view that the reimbursement of a subsidiary's net loss by the parent represents a capital expenditure. The contribution merely adds to the parent's capital investment recoverable tax free on liquidation of the corporation.

Had the taxpayer adequately financed Stages at the outset and at that time contributed an amount equal to the net loss sustained in 1936, the advance would simply have operated to increase taxpayer's capital investment. The taxpayer cannot alter the character of its investment in Stages by reason of having deferred the investment until further capital was needed. For the reason, therefore, that the accrual of the obligation under the contract to make up Stages' deficits was the accrual of a capital expenditure, it is not deductible by the taxpayer. Cf. *Welch* v. *Helvering,* 290 U. S. 111.

There is yet another and alternative reason why the contention, that the taxpayer's contract

to bear Stages' deficits gave rise to a deductible business expense in 1936, is without merit. The contention is based on the fallacious assumption that their respective businesses can be viewed as a whole for tax purposes.

As seen above, Congress, in enacting the Revenue Act of 1934, and again in the Revenue Act of 1936, denied parent and subsidiary corporations the right to make consolidated tax returns. The legislative intent in so doing is clearly revealed as requiring proper allocation between subsidiary and parant of income and expenses, and separate reporting thereof for tax purposes by each. In the absence of any contract by the taxpayer to reimburse Stages for its operating losses, it is clear, as seen above, that the taxpayer could get no tax benefit from such losses. Is the situation altered by reason of the fact of the taxpayer's contract to reimburse Stages for such losses?

In the absence of any contract the loss would have been borne ultimately by the taxpayer as sole owner of Stages. That necessarily is true in any case of a parent and wholly owned subsidiary. The subsidiary's gains come to the parent and likewise the losses. Despite that, however, the requirement of the Revenue Acts of 1934 and 1936 that their income and expenses be separately reported can only mean that the operating losses of the subsidiary cannot be reported as a deduction by the parent. It seems clear that

there is no escape to be had from this rule of law by reason of the fact that there has been a formal contract between the corporations requiring the parent to shoulder the subsidiary's loss via a mere book entry—when in the very nature of things that would happen anyway. Nor does the language of the Revenue Act of 1936 permit such a formalistic matter to alter tax liability.

The language of Section 23, allowing deductions for ordinary and necessary business expenses, must be read against the legislative history of the decision to deny parent and subsidiary corporations the consolidated return and require instead separate and distinct reports of income and expenses by each. So read, it is clear that ordinary and necessary expenses can embrace only those of the taxpayer's business as distinguished from the business of its subsidiary or the business of both together. In other words, business expenses must be allocated so as to be the expense of the parent *or* the subsidiary and not the expense of both. This accords with previous decisions of this Court holding losses sustained by one taxpayer are not deductible by another even though there is a close business relation between the two and indeed one is owned by the other. *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435; *Dalton* v. *Bowers*, 287 U. S. 404; *Burnet* v. *Clark*, 287 U. S. 410. Cf. *Burnet* v. *Commonwealth Imp. Co., supra.*

The business of the taxpayer included neither interstate nor intrastate carriage in California. The net loss of Stages was, by the taxpayer's books, attributable solely to California carriage, and the soundness of the allocation method followed is not in issue. There is nothing in the record that in any way indicates that Stages sustained a net loss in 1936 because of any service it rendered the taxpayer, i. e., synchronization of their respective schedules. It follows, therefore, that the net loss reflected expenses, taxes, salaries, etc., allocable only to Stages' operation. Payment of that loss by the taxpayer would not make those expenses ordinary and necessary expenses of its business. Cf. *Welch* v. *Helvering,* 290 U. S. 111. Nor does the fact that the taxpayer had contracted to make the payment alter the case. At best it was only a contract to pay the business expenses of another and in such a situation the contractual element is not significant. *Deputy* v. *du Pont*, 308 U. S. 488. If business exigency cannot make such a payment a business expense of a parent corporation surely dignifying the situation with a contract will not alter the fact that the payment is simply of another's expenses.

At this point the decision of the English Court of Appeals in *Odhams Press, Ltd.* v. *Cook,* 56 T. L. R. 704, is of interest. There the parent corporation, a printing establishment, had cancelled on its books an amount owed it by a wholly

owned subsidiary, a publishing company, representing the subsidiary's net loss for the year. The parent corporation sought to deduct this amount as money laid out or expended for the purposes of the trade.

In denying the sought-for deduction the Lord Chancellor observed:

> No doubt it was better for the appellants that its subsidiary companies, and this one among them, should prosper, and not be weighed down with debts. The same would be equally true of any company holding shares in another company and having trading relations with it. It is tempting to treat what I have called the subsidiary company as if it was part and parcel of the appellants, but, as the Master of the Rolls points out, the two companies are separate taxable persons. The trade or business of one company, even though it may affect very closely the trade or business of another, is not the same as that other's trade or business. * * *

Viscount Maughan wrote an opinion to similar effect.

In harmony with this English case are domestic decisions denying parent corporations any deduction for payments to subsidiaries for operating losses notwithstanding a business relation between the two corporations. *Esmond Mills* v. *Commissioner*, 132 F. 2d 753 (C. C. A. 1st), pending on petition for certiorari, No. 865, this Term; *Walker* v.

Gulf & I. Ry. Co. of Texas, 269 Fed. 885 (C. C. A. 5th).[18]

In essence the taxpayer seeks to bridge the legal chasm between it and its subsidiary by a contract so as to effect a consolidated return reflecting the net operating loss of the subsidiary. The decision of Congress, however, to require such corporations to file separate and individual returns for the tax year in question precludes the taxpayer from so doing. After enactment of the Revenue Act of 1934 its choice was to dissolve Stages or accept the tax consequences. Having chosen to operate through Stages as a separate corporation for 1936, no arrangements for book entries which the taxpayer had with its subsidiary can defeat the Commissioner's right to restrict the taxpayer to deduction of expenses allocable solely to its business. *Higgins* v. *Smith,* 308 U. S. 473.

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[18] The unreported memorandum decision in *Shasta Water Co.* v. *Commissioner,* decided February 6, 1942 (Prentice-Hall B. T. A. Memorandum Decisions, par. 42077), allowed payments to a subsidiary as advertising expenses. The subsidiary advertised the taxpayer's separate business and thus the payments made to the subsidiary were an expense of the taxpayer's own business. The case did not turn on the stock relationship, but wholly on the business relationship. The payments were measured by the subsidiary's losses, but this would merely create a doubt whether the *amount* of the deduction was correct.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted.

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SUPREME COURT OF THE UNITED STATES.

No. 552.—October Term, 1942.

Interstate Transit Lines, Petitioner, *vs.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

[June 14, 1943.]

Mr. Justice Reed delivered the opinion of the Court.

This case involves a claim by the taxpayer to treatment of itself and a subsidiary as a single taxable person. The writ of certiorari was granted because of uncertainties in this area of important federal tax law. See *Moline Properties, Inc.* v. *Commissioner*, No. 660, October Term, 1942, decided June 1, 1943, n. 1. Petitioner Interstate Transit Lines, sought to deduct $28,100.66 as an ordinary and necessary business expense for the year 1936. § 23(a), Revenue Act of 1936.[1] This sum represented a credit to its subsidiary Union Pacific Stages of California pursuant to a contract by which petitioner was to be liable for all operating deficits of the subsidiary. The claimed deduction was disallowed and a deficiency determined. The Board of Tax Appeals sustained the Commissioner and the Circuit Court of Appeals has affirmed the Board. *Interstate Transit Lines* v. *Commissioner*, 44 B. T. A. 957; 130 F. 2d 136.

Petitioner, a Nebraska corporation, operated an interstate bus transportation line between Illinois and California, and Missouri and Wyoming, and did an intrastate business in most of the states en route. Because of its foreign incorporation, petitioner was barred, under the California Railroad Commission's interpretation of California law, from obtaining a certificate of public convenience to do intrastate business in California. To avoid this situation, petitioner in 1930 organized Stages in California as its wholly owned subsidiary to do the business it was unable to do.

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1 49 Stat. 1648:

"Sec. 23 Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

"(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . ."

It contracted with Stages that Stages was to operate solely for petitioner's benefit and under petitioner's direction; all profits were to be paid to petitioner and it was to reimburse Stages for any operating deficit. In addition to its own intrastate business, Stages was to carry on all of petitioner's interstate business in California, the agreement providing that as each party's buses crossed the state line, the other became its lessee. The lessee was to pay the lessor five cents per mile operated by the bus in the lessee's custody. All this resulted in no change and no added expense in the business formerly done in respects other than accounting except for the addition to the gross revenues of the enterprise of the proceeds of intrastate California business. Petitioner kept Stages' accounts, managed its finances and paid its bills and payroll. Each month petitioner apportioned between the two companies the revenues and expenses on the basis of passenger and traffic mileage. On the books of each a "clearing account" with the other showed the absorption by petitioner of Stages annual deficit or profit. It is the 1936 operating deficit of Stages, entered on the books of both on December 31 of that year, which petitioner now seeks to deduct as its business expense. Some years after 1936, by reason of a change in California law or its interpretation, petitioner became able to conduct intrastate business in California. Consequently Stages was dissolved and its assets and franchises transferred to petitioner. In 1932 and 1933 consolidated income tax returns were filed by petitioner pursuant to § 141 of the Revenue Act of 1932, 47 Stat. 169, 213.

Whether phrased as the payment of an expense in a business conducted for a principal by an agent or as a case where equity and reality require that the separate corporate identities be ignored or as the incurring under contract of a necessary expense, petitioner's argument for its success depends on the contention that Stages' operating deficit is an expense of petitioner's business. Without this keystone the entire argument must fall. And we examine the argument in the light of the now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer. *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440; *Deputy* v. *du Pont*, 308 U. S. 488, 493. The decision of the two courts below is that this burden has not been met.

This is not the case of a mere branch or division of a business conducted solely for convenience's sake under a separate corporate form. Petitioner did an interstate bus business and was a corporation foreign to California. On the other hand the business of Stages in the tax year in question was both interstate and intrastate. For petitioner to engage in intrastate business in California was, on the findings, illegal. Thus, the businesses of the two companies were distinct. Cf. *Edwards* v. *Chile Copper Co.*, 270 U. S. 452, 454, 456; *Texas-Empire Pipe Line Co.* v. *Commissioner*, 127 F. 2d 220. Even assuming that the interstate business of Stages could be the business of the petitioner,[2] it follows that at most only that part of the deficit attributable to Stages' interstate business could be an expense of petitioner's business and petitioner could not conceivably deduct as a business expense the cost of Stages' intrastate business. There was no showing below as to the allocation of the deductions sought as between Stages' intrastate and interstate business. There is thus no record requiring a further examination of petitioner's argument since in the absence of affirmative proof to the contrary we must assume that the entire deficiency was found correctly by the Commissioner and that the deficit is attributable to Stages' intrastate business.

It is no answer to this defect of proof that petitioner was obligated by contract to assume Stages' deficit. The mere fact that the expense was incurred under contractual obligation does not of course make it the equivalent of a rightful deduction under § 23(a). That subsection limits permitted deductions to those paid or incurred "in carrying on any trade or business." The origin and nature, and not the legal form, of the expense sought to be deducted, determines the applicability of the words of § 23(a). *Deputy* v. *du Pont*, *supra*, 494. It was not the business of the taxpayer to pay the costs of operating an intrastate bus line in California. The carriage of intrastate passengers did not increase the business of the taxpayer. The profit earned on their carriage increased the taxpayer's profit but so would any other profitable activity wholly disconnected from the taxpayer's own business. As the Circuit Court pointed out, the assumption of the deficit was not dependent upon a corresponding service or benefit ren-

[2] Cf. Moline Properties, Inc. v. Commissioner, No. 660, decided June 1, 1943; Higgins v. Smith, 308 U. S. 473, 477. nn. 8-10.

dered to the petitioner by Stages in connection with petitioner's business. 130 F. 2d 136, 139.

In view of these conclusions, it is unnecessary to characterize the payment by petitioner as a capital expenditure or otherwise, or to decide whether if the record were complete petitioner and Stages should be treated as a taxable entity for the claimed purpose. Cf. *Moline Properties Inc.* v. *Commissioner, supra,* n. 2.

Affirmed.

SUPREME COURT OF THE UNITED STATES.

No. 552.—October Term, 1942.

Interstate Transit Lines, Petitioner, *vs.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

[June 14, 1943.]

Mr. Justice Jackson, dissenting.

This taxpayer operated a bus system between Chicago and Los Angeles. It could not pick up intrastate passengers in California, as it did elsewhere, because the State denied foreign corporations permission to do so. In order to obtain local traffic to help carry the cost of operating the interstate buses, taxpayer organized a wholly owned and dominated California subsidiary. This contented the local authorities, and it was granted permission to carry local business. It took over buses arriving at the state line, operated them in California, thus performing a part of the taxpayer's agreements of through carriage and benefiting from local traffic to reduce the cost. It was a common-sense business arrangement, for the purpose of making its business profitable.

The taxpayer made a contract with the subsidiary, by which the subsidiary undertook the service; the parent company became entitled to the profits and assumed the losses. The taxpayer agreed to reimburse the subsidiary for any operating deficit. This, too, was a common-sense business arrangement. To pay its wholly owned subsidiary more would be pointless, for it would only come back. To pay it less would result in its bankruptcy to the injury of creditors. So the taxpayer agreed that the operating deficits should be the measure of its contractual obligation to the subsidiary.

There is no suggestion that this arrangement was for tax avoidance, or for that matter that it did not actually reduce taxpayer's costs and thus increase its tax liability. The Commissioner ruled, however, that the amount of operating deficit paid by the taxpayer was not a business expense.

To require the Commissioner in all cases to allow a deduction so fixed might be turned by the unscrupulous to tax evasion ends. It could then, through its controlled subsidiary, make expenditures not properly allowable as business expense, but get them allowed as part of the deficit assumed by contract. Of course the Commissioner is not obliged to allow this, or any other arrangement, when it is used as a cover for tax skullduggery. Examination of the items is open to the Commissioner. But this deduction has been denied, not for such reasons, but upon a legal theory which I think is erroneous.

The taxpayer took inconsistent positions: first, that the corporate entity of the subsidiary should be disregarded and the two companies taxed on a consolidated basis; second, that the amount was a proper deduction under the contract, which of course implies existence of two parties to contract. The Government, not to be outdone in the matter of inconsistency, denied the separate entity theory and also disregarded the contract, and argues to us "the contract of the taxpayer to make good Stages' operating deficits is one pervaded by the stockholder-corporation relation. Any contribution to Stages under this contract must therefore be regarded as incident to the taxpayer's stockholder status." So the Government says the payment was not a compensation for services which the contract provides that it was, but was a "capital contribution" which the contract says it was not.

I think there is no merit in the taxpayer's theory that the Commissioner must disregard the corporate entity of the subsidiary. If a taxpayer itself creates and uses a corporation, he cannot require the Commissioner to say it isn't there.

But on the other hand, if the Commission says there are two entities, it would seem that they would be able to contract with each other, one to perform a service and the other to pay a price. The service may be, and often is, one that the taxpayer could not perform for itself, but if it is hired to build up its business, I see no reason why its proper cost is not a business expense deduction. The price need not be a fixed one, but may be determinable by costs or other contingencies; but when fixed, its amount (barring use as a device to evade) is the amount of the deduction. Cost or "cost plus" is one of the Government's own methods of contracting. It is not an illicit method for a taxpayer to employ.

But it is urged that since the taxpayer could not itself pick up local business under California law, it cannot be the business of the taxpayer in a legal sense to have a subsidiary do so, and disbursements to have local business brought in are legally foreign to its business, although for its benefit. I do not suppose the taxpayer corporation can itself legally practice law or medicine, but I would suppose if it needed legal service for its business or thought it good business to supply medical attention to injured or ailing employees, the cost would be a business deduction, even though the agent was doing what the taxpayer could not legally do for itself. The taxpayer may not be authorized to run a newspaper or put up billboards, but if it contracted for services of those who are, in order to fill vacant seats in its buses, I do not suppose its cost would be disallowed for that reason.

This company has not violated the law, even of California. Indeed, it went to this trouble to comply with it. The fact that it used a subsidiary to benefit its business in areas where its own competence was lacking can hardly invalidate the arrangement, particularly since it is insisted that the subsidiary had separate legal and tax existence. If states create dummies, business men may utilize them so long as they keep within the law, and the function of the revenue laws is not to tell them how they shall manage business, but to see that what they do has proper tax consequences.

Since the decision of this case the Tax Court has held in a very similar case that where a wholly owned subsidiary exclusively performs services essential to the business of the parent corporation, advances made by the parent to meet the subsidiary's operating deficit are deductible as a business expense. *The Texas and Pacific Railway* v. *Commission*, No. 105730, March 25, 1943. I think this is a correct rule. Judge Harron there avoids the force of this case only upon the ground that the parent corporation here could not itself engage in the business done in its behalf by the subsidiary. That distinction is good enough to get the Tax Court away from a bad rule, but I see no reason why such a deduction should be available in case of an unnecessary subsidiary and be refused in the case of one needed to comply with state laws in making a profitable enterprise. I would reverse.

The Chief Justice and Mr. Justice Murphy join in this dissent.